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THE TAXATION OF OVERSEAS ALLOWANCES AND BENEFITS

A REPORT BY THE INTER-AGENCY COMMITTEE ON OVERSEAS ALLOWANCES AND BENEFITS FOR U.S. EMPLOYEES

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I. INTRODUCTION

In its proposed tax reform legislation, the House Committee on Ways and Means would phase out, over a 4-year period, the exemptions from individual taxation of income earned abroad and from the remuneration received from Government allowances.1/ The Committee's basic view is that the exemptions for employees serving abroad are no longer justifiable and, as a matter of equitable treatment of citizens in similar employment situations, the exemptions available to Government employees must also be repealed.

The general effect of this proposed action by the Congress would be to place private-sector employees and Government employees serving abroad on an equal basis with respect to the taxation of their individual incomes. Taxable income for both public and private-sector employees, in the absence of Sections 911 and 912, includes basic compensation allowances, and other forms of cash remuneration, and it also includes noncash remuneration (e.g. the use of an employer-owned house or car).

1/ The private sector exemptions and those covering U.S. civil servants employed by International Organizations are provided in Section 911 and the public sector exemptions are provided in Section 912 of the Internal Revenue Code.

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The private-sector employer of people stationed abroad has long recognized that an important relationship exists between taxes and compensation. The average private-sector employee serving abroad could not bear the burden, given the structure of our present tax system, of the additional taxes imposed on his gross cash and noncash income. Therefore, in the private sector, employers have taken steps to absorb the additional tax burdens of their employees through various forms of tax protection and tax equalization. Rarely does a private employer fail to provide some tax relief to his employees serving abroad. If these companies are already providing tax relief to their foreign employees, in addition to the $20,000/$25,000 income exclusion, then it is only reasonable to expect that even more tax relief would be provided by the employer to offset the additional tax burden which would be imposed by repeal of Section 911. This would probably be accomplished through more liberal and widespread application of the tax equalization program. In short, private-sector employers will compensate their employees for their additional tax liability with or without the provisions of Section 911. Parenthetically, most international organizations employ a tax equalization scheme which reimburses their employees for taxes paid to their respective governments. These are, however, at least two organizations (the OECD and Asian Development Bank)

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which have no such tax equalization scheme. As a result, employees of these organizations must resolve their tax liabilities with their respective government. The only member nations of these organizations which tax their citizen-employees at all are Burma (10% of salary), the Philippines (only because the Asian Development Bank is located in Manila) and the United States (which allows a $20,000/$25,000 income exclusion under the provisions of Section 911 of the Internal Revenue Code). Clearly, repeal of Section 911 will not only impact private-sector Americans working abroad but would severely affect U.S. Civil Servants attached to certain international organizations.

Likewise, if the provisions of Section 912 were to be abolished by the Congress, the United States Government would have to recognize the relationship between taxes and compensation and provide, either through new legislation, the tax code or the compensation system, an arrangement which will ensure that the tax burden of a Government employee serving abroad

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will be the same as if they had remained in the United States. Clearly, taxing the income and allowances of Government employees serving abroad without any equalizing adjustments provided in the taxation or compensation systems would make service abroad prohibitively expensive for most people.

Overseas allowances and benefits were originally developed by Congress to cover legitimate moving and business expenses and to provide some basic recruitment and retention incentives. In the absence of a specific tax exemption, all allowances and benefits would have to be considered in the IRS context of "gross income" and subject to IRS allowable deductions for employer required business expenses. Under IRS tax procedures all allowances and benefits in "cash" or "in kind" are subject to this process and the justification of each tax deduction is in the hands of the taxpayer and subject to challenge by IRS on an individual taxpayer basis.

Employees serving their country in a foreign area would be under several predicaments in this respect: (1) An absence, initially, of tax rules to guide employee's tax determination and filing efforts and the incredible complexity of documentation requirements which now exist; (2) Only a relatively small number of American civilian employees (approximately 37,000) serve their country under a foreign flag; (3) Most employees receive allowances and

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benefits from at least a dozen pieces of legislation and under several sets of lengthy and restrictive and often difficult to interpret regulations to which they frequently do not have ready access; (4) The small number of employees who may receive a specific allowance or benefit, and their geographic dispersion, can make it impractical to operate as a group or through their employee union representatives to challenge IRS decisions when the individual's legal costs would far outweigh any advantage from doing so regardless of the equity involved; and (5) All of these employees are physically located in a foreign area where their ability to seek current tax counsel is limited and their ability to challenge IRS decisions is bound up in lengthy delays and a continuing questionable tax liability status which citizens should not be obligated to endure.

II. PURPOSE AND APPROACH

The purpose of this study by the Inter-Agency Committee on Overseas Allowances and Benefits for U.S. Employees is to assess the additional tax burden that repeal of Section 912 would have on the compensation of United States Government employees stationed abroad and to recommend an approach to the tax treatment of these allowances that is uniform and equitable to employees serving in similar employment situations in the private and public sectors both in the United States and abroad.

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The Committee's basic approach to dealing with this problem is to assume repeal of Sections 911 and 912.

The Internal Revenue Code principles and rules applicable to the compensation of private-sector employees serving abroad are then reviewed and applied to the Government employees' allowances and benefits.

In this review, the compensation value of each Government-provided allowance and benefit is examined and the issue of taxability is addressed. In those cases where the Committee found an allowance or benefit to have an unwarranted compensation value to the employee action has been taken towards eliminating this feature. In the case of some allowances and benefits it was determined that some measure of compensation was involved but that it was either insignificant or offset by other provisions of the overseas program. On the other hand, several benefits were found to contain elements of additional income; these, we believe, should be subject to IRS tax rulings.

III. GENERAL PROVISIONS OF TAX CODE SECTIONS 911 and 912

Section 911 of the Internal Revenue Code provides an exclusion of either $20,000 or $25,000 from gross income of earnings by private-sector employees who are bona fide residents of a foreign country, or who remain outside the United States for 18 months or 3 years, respectively.

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Section 912, which applies to civilian employees of the Federal Government, does not provide a lump-sum $20,000/$25,000 exclusion, but instead excludes from gross income most of the allowances paid to Federal civilian employees working outside of the United States.

The House Ways and Means Committee proposes to abolish Section 911 because they believe this section ".....operates indiscriminately and inequitably, providing no benefits to those citizens living in countries with tax rates equaling or exceeding the United States tax rate and double benefits to those citizens who are exempt from foreign taxation....."[2/] Concurrent with abolition of Section 911, the Committee proposes to repeal Section 912 so that "....private citizens abroad not be treated unfairly in comparison with Government employees working outside the United States."[3/]

IV. PRIVATE-SECTOR APPLICATION OF TAX CODE SECTION 911

The Internal Revenue Code provides that "earned income" (including noncash remuneration and allowances and reimbursements) and "unearned income" (dividends, interest, capital gains, etc.) of private-sector employees stationed abroad are subject to Federal taxation. However, under Section 911, the tax exemption of $20,000 or $25,000 is allowed on earned

2/ From January 25, 1975 paper "Proposed Repeal of Tax Exemption for Allowances Paid to Overseas Employees," David Foster, U.S. Treasury, Page 3.

3/ Ibid: page 4.

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income.[4] In addition, expenses incident to earned income may be deductible to the extent that the deductions are computed as a ratio of taxable income to gross income. Other deductible expenses, such as medical, mortgage interest and charitable contributions may be claimed in the regular manner.

More specifically, although the Committee members found it difficult to fully comprehend the tax rules and computations, it appears that private-sector employees are allowed an exemption of either $20,000 or $25,000, as well as deductions for certain expenses, allocable to earned income, based on the ratio of taxable income to gross income. Thus, an employee with a gross income of $50,000, a tax exemption of $20,000, and an adjusted gross income of $30,000 is entitled to claim 60 percent of these allowable expenses as deductions from his adjusted gross income ($30,000 divided by $50,000 equals .60). In addition, the private-sector employee abroad can claim medical expenses, charitable contributions, etc. in the same manner as the employee in the U.S.

Most United States corporations, employing United States citizens in foreign localities, provide additional tax relief as a matter of corporate policy.[5] The most popular means of assistance is "tax equalization" under which a company

4/ IRS Publication 54, page 7.

5/ Of 265 companies surveyed, only 18 (7 percent) provide no tax assistance. (Organization Resources Counselors, Inc., "ORC Survey of Personnel Practices and Compensation for Expatriate Employees", July 1974).

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pays the employee the sum of his total actual foreign tax, plus an amount required to cover any domestic tax in excess of a hypothetical tax. Other companies, under a "foreign tax protection" plan, pay the employee any actual foreign tax in excess of a hypothetical domestic tax. The fact that private-sector citizens serving abroad receive tax allowances from their employers indicates that the existing provisions of the Internal Revenue Code do not equitably compensate for the employee's tax liability. It should also be noted that many companies (112 out of 265) pay a "tax on tax" allowance; that is, they will pay taxes generated by either of the above tax allowances.

V. APPLICATION OF PRIVATE-SECTOR TAX CODE PROVISIONS TO FEDERAL CIVILIAN EMPLOYEES

Assuming Section 912 is repealed, then in the absence of any new tax code provisions, employees in the public sector would continue to compute their taxes in accordance with the instructions for filing individual income tax returns. Moreover, since the exemptions that were available under Sections 911 and 912 would no longer be available to anyone, then Government employees and private employees alike would have to declare their total gross income and claim the allowable exemptions and deductions in accordance with the tax code provisions that apply to all United States taxpayers serving abroad. The $20,000 or $25,000 exemption

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now available to private-sector employees would not be allowable and expenses could not be prorated. Expenses required incident to the earning of income could be deducted in their entirety. Reimbursements in excess of expenses would be considered additional income for tax purposes.

A summary of IRS tax code provisions that may be applicable to allowances paid Federal civilian employees serving abroad is included in Appendix 1.

VI. APPLICATION OF THE PRIVATE-SECTOR TAX CODE PROVISIONS TO GOVERNMENT ALLOWANCES AND BENEFITS

To apply the private-sector tax code provisions to the allowances and benefits received by Government employees, the term "allowances" as well as other forms of benefits, must now be considered in an "income-expense" environment and not treated merely as additional income. Following the guidelines provided by IRS, a determination must first be made as to which allowances and benefits provide additional income to the employees that cannot be offset by expenses, and which provide only reimbursement for expenses accrued in taking actions required by the employer. With these considerations in mind, the Inter-Agency Committee on Overseas Allowances and Benefits for U.S. Employees examined each allowance and benefit to determine its possible tax status in the context of this income and expense environment. The Committee's

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findings are shown below:

A. Relocation Allowances and Benefits

1. Movement and Storage of Household Goods

The IRS considers the cost of moving household goods incidental to employment (transportation, packing, crating, intransit storage, and insurance) as deductible. Therefore, to the extent that reimbursement does not exceed the expense of moving the household goods, such reimbursement would be fully deductible and would not be considered as providing additional income.

Since household goods moving expenses to, from, or between foreign areas are normally paid by means of a Government bill of lading, reimbursement would not exceed actual expenses. Accordingly, this allowance would not be subject to taxation. However, the IRS only allows deductions for intransit storage for a period of 30 days. Based on the needs of Federal employees involved in transfers, the Committee has recommended a total intransit storage period not in excess of 180 days. When that recommendation is fully implemented, and if an employee's storage exceeds 30 days, reimbursement for the excess storage would, in the eyes of the IRS, constitute an increment to income and would be taxable. As the 180 day intransit storage period is considered as a work related expense, the Committee believes that it should not be taxed.

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In addition, the Committee has been informally advised by the IRS that long-term (nontemporary) storage is not considered a deductible expense and, thus, becomes taxable income. Since this type of storage is allowed in lieu of transportation of household and temporary storage when available quarters overseas cannot accommodate all or part of the employee's weight allowance, we regard this an unreasonable position because this allowance is clearly a reimbursement for an unavoidable employer-required expense.

2. Transportation of Privately Owned Vehicles

Reimbursement for the expense of shipping an automobile to a new residence would not be regarded as additional income by IRS and would not be taxed if the reimbursement does not exceed the amount of expenses.

3. Temporary Lodgings Allowance

The Committee has recommended a temporary quarters subsistence allowance to replace two temporary lodging allowances and the supplementary post allowance. The IRS currently allows temporary lodgings and meals as a deductible expense, and the Committee recommendation provides only for payment of actual expenses. Recipients of this allowance will be adversely affected because the IRS recognizes expenses for this kind of allowance only up to $1,000 and will not allow any claim for expenses of this nature

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beyond a 30-day period. These restrictions would have the effect of increasing taxable income for (1) employees paid in excess of $1,000 during any 30-day period, or (2) employees who receive this allowance for a period in excess of 30 days. We believe that this allowance has been restructured by our recommendation in such a manner that it can only reimburse employees for necessary employer-required expenses. We also believe that the 30-day/$1,000 limitation currently used by IRS would impose an unfair tax burden upon employees who must necessarily occupy temporary quarters for reasons beyond their control.

4. Transfer Allowance

There was nothing in the tax literature available to the Committee which even suggested that this allowance could be considered as anything but income. Accordingly, any amount received under the recommended restructured transfer allowance would constitute taxable income. This is not regarded as reasonable since the allowance has been tailored in such a manner that it can only be used to reimburse employees for actual expenses necessarily incurred incident to a change of residence for the Government's convenience.

5. Per Diem

Travel per diem for the employee and his family is considered a business expense and would not be taxable.

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The IRS currently allows non-Government travelers to claim either a flat $44 or the maximum per diem authorized for Federal Government employees (IRS ruling 74-433).

6. Home Leave

The taxable status of home leave itself would not change since the income received while on leave is currently considered taxable.

7. Home Leave Travel

Where home leave is a formal requirement of the employer, the Committee believes that the amounts paid by the employer for the transportation and per diem of the employee and his dependents would be regarded by the IRS as reimbursement for a business expense and would be deductible from gross income. However, it is possible that employees who are authorized, but not required, to take home leave would be adversely affected. In the latter case, the amount of money expended by the employer on transportation and per diem for the employee and his dependents would probably be regarded as an increment to income and subject to tax. The variable tax status of this benefit would generate an undesirable inequity among Federal employees.

8. Family Visitation Travel/Emergency Visitation Travel

These allowances would probably be regarded by the IRS as income rather than as reimbursement for expenses

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since such travel is not a requirement of the employer. Thus, the full amount would be taxed. The Committee believes that only the added income generated by these allowances should be subject to tax since employees receiving these allowances are stationed outside the United States as a necessary condition of their employment. But to exclude from taxes the full value of these allowances would place an employee serving abroad at an advantage when compared with his counterpart in the United States who may also perform such travel. In order to avoid this inequity, we believe that the transportation and per diem payable between the foreign duty station and the point of entry/exit in the United States should be regarded as reimbursement of an expense necessitated by the conditions of employment. On the other hand, the cost to the Government of transportation and per diem from the point of entry in the U.S. to the leave address (and from the leave address to the point of exit) is viewed as added income and should be subject to tax.

9. Evacuation Payments

The Committee views evacuation payments as reimbursement for expenses and not as additional net income. However, to the extent that evacuation payments exceed the actual costs or expenses of the employee, then the amount of excess reimbursement would be regarded by IRS as additional income subject to tax.

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B. Allowances for Extraordinary Living Costs

1. Post Allowance

The Post Allowance compensates employees for serving at a post where the cost of living is substantially higher than in Washington, D.C. This allowance simply provides a means of offsetting higher costs incurred by employees as a result of their assignment to a particular overseas post. As these higher costs would not be incurred if their post of assignment was Washington, D.C., there is no intentional "added compensation value" in the post allowance. However, the allowance would probably be considered by the IRS as taxable income since similar allowances in the private sector are treated in that manner.

The Committee has made several recommendations concerning the administration of the post allowance. One of these recommendations agreed with the GAO criticism that housing costs should be excluded from the spendable income tables. If this recommendation is adopted, we feel that the allowance will represent only reimbursement for extra costs and, as a result, there would be no compensation value connected with this allowance which should be considered for taxable income purposes.

Should the Ways and Means Committee decide to repeal Section 912, the additional tax liability that would

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result from that action could be accommodated in the Post Allowance/Cost-of-Living Allowance spendable income payment tables. In that eventuality "tax expenditures" could be treated as an expenditure item in the same way as other "consumer expenditures" are treated. If the additional tax liability was included in the Post Allowance process, then the monetary impact on the employees as a result of the repeal of Section 912 could be minimized. However, it is the position of the Committee that the post allowance should not be considered as income for tax purposes.

2. The Separate Maintenance Allowance

The Separate Maintenance Allowance (SMA) is intended to help offset the additional expenses of maintaining dependents elsewhere as a result of the employee not being able to take his dependents to his post of assignment. The SMA helps to offset out-of-pocket costs incurred in connection with maintaining two households.

The nature of this allowance is such that it only provides reimbursement for employer-required expenses; there is no intention of providing additional compensation through this allowance. However, as in the case of the post allowance, the IRS would probably regard the value of the SMA as taxable income. The taxpayer receiving the SMA would not be able to establish deductions for meals or travel as

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"business expenses away from home," as the IRS defines the employee's "tax home" as the principal place of business, employment, or post of duty, regardless of where the family residence is maintained.

Since the SMA simply offsets costs incurred on behalf of the employer in situations over which the employee has no control, we do not believe that the allowance should be taxed as constituting incremental income to the employee.

C. Hardship Incentives

1. Post Differential

It was the consensus of the Committee that post differential payments, based on environmental conditions at the post of assignment, are incremental income and should continue to be taxed. Under IRS rules salary differentials and similar amounts that increase basic pay as an inducement to accept a less desirable post of duty are considered taxable income.

2. Rest and Recuperation Travel

This benefit provides temporary relief from certain posts where severe conditions exist and involves only travel from and to the employee's post. This travel is not performed for the purpose of conducting business; instead, it is clearly intended for recreational purposes.

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Accordingly we feel that the IRS would probably consider this as taxable income. As in the case of other taxed benefits, employees could possibly challenge this IRS position on the grounds that the travel was employer-provided for the benefit of the employer and for the purpose of maintaining the efficiency of the employee. If the employee were "required by the Government" to use the R&R benefit, we believe that the travel would be more easily regarded a business expense to the employee and it would be deductible from gross income. In any case, it is unlikely that IRS will accept either posture without clarification of its tax status by Congress or by lengthy and costly tax litigation either by employees or their union representatives. Thus, for the present, R&R travel must be considered taxable income to the recipient.

It is the opinion of the Committee that R&R travel was provided by the Congress as a necessary employer-related benefit to maintain the morale and efficiency of employees assigned to difficult locations where reasonably low cost vacations, providing a change of environment, were not economically available to the employee. In this context, we believe that the payment of travel for those employees headquartered at overseas posts designated for rest and recuperation does not constitute incremental income and should not be taxed.

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3. Unhealthful Post Credit

This benefit permits employees assigned to certain designated posts to elect to receive, in lieu of post differential payments, retirement credit at the rate of 1½ years for each year of service. In accordance with the present tax legislation pertaining to taxation of annuities, the additional annuity earned under this benefit is presently taxed.

D. Housing

All Federal civilian employees on a foreign assignment presently receive either free Government-provided housing or a living quarters allowance designed to cover the average cost of housing in the particular foreign location. This benefit is regarded as a recruitment and retention incentive required to attract qualified employees for foreign service assignments. Under current IRS rules salary differentials and other increments to basic compensation which are paid as an inducement to accept a less desirable post of duty are income for tax purposes. For housing provided "in kind," current IRS practice requires that the fair market rental value of property provided by the employer, for services rendered, be included as income. Under current IRS rules it appears that any amount received by an employee in the form of a living quarters allowance is taxable income. Employees provided Government housing would also be required to report its fair market value as income.

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Some employees, such as those occupying representational Government quarters or Government housing where no private leasing arrangements are possible, might be able to convince their IRS office that they are required to accept lodging on the employer's premises as a condition of employment (i.e. the acceptance of the housing is essential to enable the employee to properly perform necessary duties). In such cases the value of the housing would not constitute taxable income to the employee.

As employer and tax collector, there is some question about the propriety of taxing the fair rental value of property when the actual costs to the U.S. Government are not commensurate with fair rental value (e.g. property acquired as a gift or at low cost by use of excess foreign currencies or the special bargaining power of the U.S. Government as tenant). Moreover, the employee does not have the normal option of leasing or subleasing the housing to someone else; therefore, fair rental may not be an accurate or fair measurement of its value to the employee.

It is the position of the Committee that taxation, based on the fair market value of housing furnished the employee, would be inequitable and unfair. The inequity of this approach becomes obvious when one considers the extreme variations in housing costs around the world and the fact that

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many employees would then be forced to pay enormous taxes for the privilege of living in substandard housing in areas where housing of any type is in short supply and therefore extremely expensive. It is interesting to note that in some foreign locations the cost of adequate housing exceeds salary payments for many employees.

It was recognized that this benefit or allowance had elements of both "added compensation" (which should be taxed) and "reimbursement for higher housing costs abroad" (which is due to housing cost conditions and is therefore a necessary business expense abroad). It was decided that the most feasible way to determine the "extra compensation" value would be to relate the benefit to the average net cost of housing in the U.S. Several difficulties in approach were noted by the Committee:

1. It is not possible to establish a simplified methodology to equitably determine how much the "average" employee would spend for housing in Washington or any other city in the U.S., and the "net value" to the employee.

2. While furnished quarters or a housing allowance may have a compensatory value for an employee overseas, it may be substantially offset by the fact that employees spending most of their careers in overseas areas are deprived

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of the opportunity to manage their real estate investments in a manner which most effectively increases their net worth. In this connection, it is noted that the single greatest part of most employees' net worth at the end of a Government career is in their residences.

3. The compensatory value, if any, is much less than might be assumed and probably ranges between $1,000 and $2,500 per year after consideration of all relevant factors and without regard to loss of investment opportunity if one is stationed permanently in one city. (The OMB study estimated the compensatory value at $1,400 to $2,600, but did not include any factor for the appreciation in value realized by the average U.S. homeowner.)

The Committee recognizes that the living quarters allowances, as currently administered, provide an incentive portion of up to 10% of the employees' housing expenditures for those spending less than the allowance. As an "incentive" payment it appears that this would be taxable income. However, the Committee has recommended the abolishment of this feature of the allowance.

E. Allowances and Benefits due to Inadequate Community Services

1. Education Allowance and Government-provided Schools

The purpose of the education allowance is to assist employees serving abroad in meeting the cost of obtaining

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the equivalent of the elementary and secondary educational services ordinarily provided without charge by public schools in the United States. For locations, with U.S. Government subsidized or DOD operated schools, the education allowance is based on established charges for those facilities. Department of Defense employees do not receive this allowance. Instead, the DOD either provides schools without charge or contracts directly with an acceptable school in the foreign locality on behalf of its civilian employees. Thus, some employees receive the education allowance while others receive this benefit "in kind."

Educational expenses paid by the employer generally must be included in income for tax purposes. While deductions are allowed for education of the employee when required by the employer or by the trade or profession, the Committee was unable to identify any valid deductions for the education of dependent children. It appears that any education benefit not specifically excluded by law from taxation would be considered by the IRS as taxable income. The Committee recognizes that the Congress did allow for this by building into the draft legislation on taxation a $100 per month tuition deduction, not to exceed earned income without the U.S., until the dependent reaches the age of 19. The Committee notes that this proposal does not cover the charges

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levied upon employees of non-Defense Agencies for attendance at DOD operated schools abroad. It also falls short of covering school costs for many foreign schools suitable for American children and it covers only a small portion of the costs where boarding schools represent the only real choice to parents.

The Committee believes in general that this benefit is not additional income and therefore should not be taxed. It might be argued that for those employees serving abroad who pay no local or state tax in the United States which supports public schools, this benefit does represent added income. However, virtually all U.S. states--and the courts--recognize that U.S. citizen employees abroad must have a domicile somewhere in the U.S. This is particularly true for Federal employees on periodic assignment to foreign areas as they would find it difficult to convince tax authorities of any intention to be permanently domiciled in the country of assignment. Federal employees are bound by the tax laws and rules of their own tax jursidictions. Moreover, it appears that most (if not all) states apply no statute of limitations to the filing of tax returns for tax years in question.

2. Educational Travel

The purpose of this benefit is to provide travel for dependents between a post in a foreign area and a school in the U.S. for secondary and college education.

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As this travel is not required by the employer, the Committee believes that the full value of this benefit would be considered by the IRS as taxable income. The draft legislation on taxation, which provided for a $100 per month tax deduction, carefully specified that only the expenses associated with school and tuition (but not travel) could be deducted.

In reviewing this benefit, the Committee recognized that most educational travel expenses are incurred because of a necessary condition of employment. As parents of high school students in the U.S. do not incur these unusual types of transportation expenses, the Committee believes that educational travel payments for these dependents are required as a condition of foreign employment and should not be taxed. In contrast, the Committee recognized that many parents domiciled in the U.S. frequently incur sizeable transportation expenses for children attending colleges long distances from home. The Committee believes that provision of the educational travel as a fully non-taxable benefit would place employees stationed abroad at an economic advantage over their counterparts in the U.S. In order to avoid this inequity, we believe that travel payments for college attendance between the foreign duty station and the point of entry/exit in the U.S. should be regarded as reimbursement for an expense necessitated by the conditions of employment. On the other hand, reimbursement for

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travel expenses between the point of entry/exit in the U.S. and the college is viewed as added income and should be subject to U.S. tax.

3. Commissary and Exchange Privileges

At many foreign posts, Federal civilian employees have access to either U.S. military commissary/PX facilities or to employee cooperative type commissaries. In the case of military facilities there is normally a price advantage over U.S. and foreign costs as well as the opportunity to buy familiar American products. The primary advantage of employee-operated cooperative commissaries is the availability of goods which Americans often cannot find in the foreign markets or which, if available, would be prohibitively expensive. The Committee noted that the availability and use of both types of facilities are fully considered in the establishment of any post (cost-of-living) allowance for the overseas post.

While the availability of these facilities may provide some compensation value at posts where living costs are below the U.S. level, it is doubtful that the IRS or anyone could fairly determine the additional income increment for tax purposes. In view of the administrative problems associated with determining the income value of commissary and exchange facilities, and the fact that actual costs at these types of outlets are considered in the decision to provide a post (cost-of-living) allowance, the Committee strongly recommends that no tax be imposed on this benefit.

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4. Health Care, Hospitalization and Medical Examinations, Inoculations and Medical Emergency Travel

Various forms of health care, hospitalization and medical emergency travel are provided Americans abroad. These benefits are provided partly for the purposes of recruitment and retention, but more importantly for maintenance of the morale, efficiency and physical well being of the employees and dependents in a foreign area. When these benefits are provided free or at nominal cost at the overseas location, they are considered in developing any post (cost-of-living) allowance for that particular duty station.

The Committee understands that under current laws and IRS rules, employers in the private sector can provide formal medical programs for the benefit of their employees without any increased tax liability to those employees. The Committee believes that the U.S. Government medical program should be considered this type of benefit, and employees should receive these employer-provided services without incurring any tax taxability. While health programs provided by the employer for reconditioning, health restoring, and rehabilitation are clearly taxable, these are not the types of services provided by the Government for Americans abroad.

Since medical emergency travel is not normally included in medical programs of private employers in the U.S., the IRS might regard reimbursement for this travel as taxable

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income. The Committee believes, however, that this benefit is directly related to the needs of the employer since it provides medical emergency travel where adequate medical facilities are not available at the specific duty station. For this reason, the Committee concluded that this travel benefit is not additional income and should not be subject to tax.

5. Medical Services After Death or Separation of Employee

This benefit provides medical services for employees or their dependents in cases of acute hardship after the death or separation of an employee when the services are required for illness or injury proximate to a previous overseas assignment. Since these medical services are employment-related, and would not be incurred but for the overseas service, the Committee believes that no additional compensation is received by the employee or dependents. For this reason, the Committee believes that this benefit should not be taxed.

6. Transportation at Overseas Posts

At some overseas posts Government-owned vehicles are used to provide transportation between residences and the office when public transportation, other than taxicabs, are unavailable or unsafe. Further included is transportation for employees and dependents to and from schools, medical facilities, and other such uses as deemed necessary..

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The intent in providing this benefit is not to augment compensation to the employee, but rather to aid the employer in maintaining a reliable and dependable work force. The Comptroller General has long held that where use of Government-owned vehicles is deemed to be in the interest of the Government such use is legitimate. The GAO has also recommended that the U.S. Government impose reasonable charges on the employees for the use of these transportation services.

As the Government charges for these services, except in the most unusual or unique circumstances, it is unlikely that the IRS would consider them to be additional taxable compensation. Wherever the charges imposed upon employees for Government transportation are less than alternative costs of taxicabs or automobiles, this use of Government-provided transportation is considered in determining the cost-of-living level at the location for post (cost-of-living) allowance purposes.

VII. ACTIONS NECESSARY TO ESTABLISH AN EQUITABLE TAX SYSTEM FOR OVERSEAS GOVERNMENT EMPLOYEES

In section IV of this paper, we discussed some of the methods by which private-sector employers compensate for the added tax burden assumed by their employees. Those included tax equalizations, foreign tax credits, and even tax-on-tax allowances. If these companies are providing tax relief to their foreign employees, in addition to the $20,000/$25,000

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income exclusion, then it is only reasonable to expect that even more tax relief will be provided by the employer to offset the additional tax burden which will be imposed by repeal of Section 911. This would probably be accomplished through more liberal and widespread application of the tax equalization program. In short, private-sector employers will compensate their employees for their additional tax liability with or without the provisions of Section 911.

However, with respect to repeal of Section 912, United States citizens employed in foreign countries by the Federal Government will not be compensated for their additional tax burden. Their employer (the Federal Government) could only provide the needed relief through additional legislation authorizing tax compensation analagous to that provided in the private sector or changing the tax code or IRS tax rulings. We believe that in addressing the repeal of Section 911, the Congress recognized the employer's responsibility to compensate for their employee's added tax burden.6/ We believe that as an employer, the Government, too, has a responsibility to compensate its employees for their added tax burden.

Section VI of this paper discussed the compensation value of each Government-provided allowance and benefit and examined how they might be viewed by the IRS in terms of tax liability.

6/ Page 3 of the Foster discussion paper, described in footnote 2, reads in pertinent part as follows: "To the extent there are additional costs in locating employees abroad, those costs should be borne by the employer and not subsidized by the Federal Government."

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Some benefits were found to contain elements of additional income and are rightfully subject to tax. Most of these benefits, however, result from employment conditions in a foreign environment. Based on current tax rules and practice it appears that most of the overseas allowances and benefits would be considered as "gross income" by IRS authorities and the development of a rationale for "deductions" would be placed in the hands of each foreign service taxpayer in the absence of affirmative IRS action.

As the U.S. Government is both the employer and the tax collector in this situation, Federal Agencies bear a special responsibility to their employees in the determination of tax responsibility and liability no less than that already accepted by private organizations with employees in the same situation. Given this responsibility, the U.S. Government should seriously consider the payroll and accounting system costs associated with repeal of Section 912. As employer, the U.S. Government would have to bear the additional costs of adjusting a wide variety of manual and computer oriented payroll systems to maintain records and to implement the necessary tax withholding. Additionally, the Government would have the normal employer responsibility of assisting employees in determining the taxable portions of the various allowances and benefits. The Government should also anticipate additional costs of legal proceedings as the taxation of various allowances and benefits are contested

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by foreign service employees and their union representatives. The uncertain nature of the full tax liability, would require detailed record keeping and accountability for essentially all expenses associated with foreign employment. These additional costs to the Government and the employee should be weighed against the revenues expected from the taxation of the overseas allowances and benefits.

This study by the Inter-Agency Committee on Overseas Allowances and Benefits for U.S. Employees indicates that there are three approaches that the Government could take to establish an equitable tax system for Overseas Government employees if Section 912 is repealed.

The first possible approach would be to prepare separate legislation specifically dealing with the issue of taxation of overseas allowances and benefits. This bill should stipulate those benefits which are regarded by the Congress as including elements of taxable compensation and should provide guidelines for their taxation. This law should also carefully stipulate which allowances and benefits are to be tax free. This action by Congress would eliminate the current uncertainties surrounding employee tax liability.

A second possible approach would be for Congress to authorize a separate "tax equalization allowance" to be used by Federal Agencies to offset the additional tax liability which would accrue with repeal of Section 912. This allowance would

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be similar to that generally used by private organizations for equating their employees foreign tax obligation with that of other employees who remain in the U.S. This equalization allowance would not apply to any benefit which provides additional compensation for employees abroad.

While new legislation is a possible answer to the question of inequitable allowance and benefit taxation, it appears that the U.S. Government as employer and tax collector is in a unique position to eliminate the need for such an extensive and costly program by a clarification of tax rules and procedures as they apply to employees abroad. Under this approach, the IRS would implement a basic set of specific tax revenue rulings describing the tax status of each overseas allowance and benefit. The Inter-Agency Committee believes that many of the current IRS tax rules and procedures, such as the time and dollar limitations on moving and storage of household goods and temporary subsistence costs, are based solely on domestic experience and are not properly related to the realities of living abroad. More importantly, the IRS has not openly addressed the tax status of most of these foreign service benefits. The Committee believes that IRS should act responsibly to develop more complete and more realistic rules for employees involved in transfers across national boundaries and in far flung areas of the world. In developing these rules, careful consideration should be given to the Congressional intent

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underlying the allowance legislation. Only those allowances containing measurable income value to the Federal employee should be taxed.

The Inter-Agency Committee on Overseas Allowances and Benefits for U.S. Employees is willing to work closely with the Congress and the IRS to develop a system to deal equitably with the compensation and taxation of Americans serving abroad.

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SUMMARY OF INTERNAL REVENUE SERVICE TAX RULES AS THEY MIGHT APPLY TO ALLOWANCES PAID TO FEDERAL CIVILIAN EMPLOYEES OUTSIDE THE CONTERMINOUS UNITED STATES

Gross Income

A. All income received as compensation for personal services

B. Cash allowances for meals or lodging

C. Fair market value of property received for services

D. Reimbursements for moving expenses

E. Moving services furnished in kind by employer

Note: If the employee is required to accept lodging on the employer's premises as a condition of employment (i.e., the acceptance of the housing is required to enable the employee to properly perform necessary duties), the value of the provided housing is not considered income for tax purposes.

Adjustments to Income

A. Moving expenses (IRS Form 3903 and Form 1040, lines 40 and 14)

1. Travel expenses, including meals and lodgings

2. Cost of moving household goods:

   Transportation

   Packing and crating

   Shipping automobile

   Intransit storage)
) for 30-day period
   Insurance)

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3. Premove househunting trips)
) $1,000 maximum)
4. Temporary lodging and meals for 30 days...))
) $2,500
5. Home sale expenses) maximum

Note: Mandatory evacuation expenses are sometimes accepted by IRS when the employee can show that evacuation was ordered by the United States Government and otherwise properly documented.

B. Employee business expenses (IRS Form 2106 and Form 1040, line 41 and 14)

1. Transportation, meals, and lodging while on business travel in the United States or foreign area
2. Temporary duty includes assignments expected to last less than one year
3. Travel expenses includes cleaning and laundry costs, baggage charges, and tips
4. Entertainment expenses if they are expected or required by employer

Note: Expenses while on home leave are not considered business but personal expenditures. However, some employees have contested this rule when they can show that the home leave is required by the United States Government and apparently some IRS field offices have not contested this deduction.

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C. Miscellaneous expenses of employees (IRS Schedule A and Form 1040)

1. Unreimbursed travel costs

2. Tax counsel and fees

3. Professional dues and publications

4. Education expenses to improve skills required by employer

Note: Representational expenses and official residence expenses can be claimed if documented and supported by certificate from the Secretary of State and certification that those would be ordinarily paid by the Government but for the lack of funds.

All of these items are deductions from gross income. Items A and B are subtracted from gross income to derive adjusted gross income (item 15, Form 1040). Item C is then subtracted from item 15 to obtain taxable income.

Any increase in gross income which is fully offset by these three forms of deductions does not represent an increase in taxable income or the resulting tax.

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